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The Impending Tax Tsunami.

The economic term, “Fiscal Cliff”, that Washington has coined is due to be take effect on January 1, 2013. I think the expression “*Tax Tsunami*” better defines the impending, huge, across-the-board tax increases that could engulf our economy.

The *Tax Tsunami* includes a 33.3% increase in the capital gains tax, and increases from 13% to 50% in the individual tax brackets, with a top rate capping at 39.6%. Higher taxes will be levied on ordinary income and dividends, plus a new Obama Care 3.8% tax on dividends, capital gains, and interest income[1]. Added to this impending economy killer is a lower threshold for the Alternative Minimum Tax, and the end of the 2% payroll tax break of the past two years.

The *Tax Tsunami* will batter small business. The Small Business Jobs Act of 2010 allowed self-employed business owners to deduct the cost of health insurance for themselves and their family in the calculation of their self-employment tax.[2] This provision will be permanently washed away in 2013.

The *Tax Tsunami* will also batter America’s medical devices industry. Starting in 2013, a 2.3% excise tax included in Obama Care will be levied on the total revenues of American medical device companies. The device tax is a levy on gross receipts (sales) instead of a more normal tax on profits. The tax will be enforced even if a company sells its products at a loss.[3] For many American medical device companies, this tax on sales will be devastating to productivity, innovation, and job creation.

The *Tax Tsunami* is an economy killer because of its destructive impact on business investment and work effort from higher tax rates on ordinary income, dividends, and capital gains, capital formation and business viability. The overall increase is unprecedented and will increase taxes by almost $500 billion.[4] Most of these taxes will cascade on small businesses and on individuals.

The Tax Policy Center, a left of center joint venture of the Brookings Institute and the Urban Institute, released its latest estimates on federal taxes for 2013. Their estimates show the average federal tax rate for American households will increase five percent and total after-tax income would fall by 6.2%. Based on their study, households would pay, on average, $3,446 more in taxes in 2013 than in 2012.[5]

Combine this torrent of taxes with the unsettling impact on consumers and investors from losing a significant portion of their anticipated cash flow being redirected to Washington from higher taxes. These tax hikes would not only damage the supply-side of the economy, but would hijack hundreds of billions of dollars of disposable income from the private sector.

The economic damage caused by the threatening *Tax Tsunami* is battering the U.S. economy every day. If a new budget agreement is not completed by the end of this year or early next year, the *Tax Tsunami* will pummel our economy. Today, I see the odds of a recession at less than 25%. However, if the *Tax Tsunami* hits, the chance of a recession would rise dramatically.

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[1] Congressional Health Care Caucus, http://health.burgess.house.gov/uploadedfiles/one_page_on_unearned_medicare_tax.pdf
[2] Washington Watch, July 18, 2012. NASE, National Association for the Self-Employed
[3] http://atr.org/obamacare-excise-tax-medical-a7023#ixzz2A9FTInBy
[4] Going over the "Fiscal Cliff" Means Significantly Higher Tax Bills for Americans. Tax Policy Center, October 01, 2012
[5] Toppling Off the Fiscal Cliff: Whose Taxes Rise and How Much? Tax Policy Center, Roberton Williams, Eric Toder, Donald Marron, Hang Nguyen, October 01, 2012

Tax Tsunami holding the country Hostage

The *Tax Tsunami* is beginning to drag down the economy as Economist Larry Kudlow has stated "like the recessionary sword of Damocles". The sword of Damocles is the imminent and ever-present peril faced by the economy of the significant tax increases scheduled to go into effect on January 1, 2013.

The National Association of Manufacturers (NAM) released a new report, Fiscal Shock: America's Economic Crisis.[6] The report demonstrates the substantial damage that the massive future tax increases and budget cuts are currently having on the U.S. economy.

The report shows that companies, both large and small, are bracing for a titanic wave of destabilizing new taxes. Companies are delaying capital and inventory purchases, not filling vacant job openings, and laying off workers. Recently released Commerce Department data illustrates that business investment stalled in September, as orders for core capital goods such as machinery and equipment softened.[7]

Furthermore, orders for core capital goods has historically been a key gauge of economic demand. The data-set is significant because it is an important component for estimating GDP growth for the U.S. I believe the Commerce Department's reported weakness in core capital goods orders is a direct result of the pending *Tax Tsunami*, and will dampen fourth quarter growth.

The approaching *Tax Tsunami* has especially frozen small business in their tracks. American small business produces roughly one-half of the privately generated GDP in the United States, a figure that has been basically unchanged since the 1970's[8]. This significant output of goods and services makes American small business owners a major engine of growth, and the world's third largest economy based on GDP, trailing only the full United States and China.

A major concern stems from the fact that the majority of small businesses pay their tax with the individual Form 1040, not a Corporate 1120. This is very important because these small business owners will see their top tax rate skyrocket to almost 45% under President Obama's plan or drop to 28% with challenger Romney's plan.[9]

Pessimism within the small-business community grew in September. The National Federation of Independent Business (NFIB) Small Business Optimism Index lost ground in September falling to 92.8.[10] The NFIB Research Foundation has collected Small Business Economic Trends data with quarterly surveys since 1974 and monthly surveys since 1986.

The NFIB's recession-level outlook was forced lower by weakening labor market indicators. Job creation plans plunged 6 points**,** job openings fell one point, and more firms reported decreases in employment than those reporting increases.

These reports and studies reveal a business owner's view of the future for the economy that has become increasingly more negative. The pending *Tax Tsunami* appears to have produced a significant and chilling effect on the economic output. The economy is already stalling, with the second quarter GDP growth at a paltry 1.3%, including a 1.2% drop in industrial production (IP) and a first estimate of third quarter GDP growth at only 2%. The economic damage caused by uncertainty of higher taxes is being inflicted daily.

Combine the torrent of these higher taxes with the disturbing future impact on consumers and investors from losing a significant portion of their anticipated annual cash flows. Higher taxes on dividends,

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[6] Fiscal Shock: America's Economic Crisis, Matthew Lavoie, October 26, 2012. The National of Manufactures
[7] http://www.census.gov/manufacturing/m3/adv/pdf/durgd.pdf
[8] Joel Popkin and Company, Small Business Share of Economic Growth, 2001, Office of Advocacy, U.S. Small Business Administration.
[9] http://www.mittromney.com/sites/default/files/shared/the_romney_program_for_economic_recovery_growth_and_jobs.pdf
[10] Small Business Optimism October 2012 Survey, The NFIB Research Foundation, October 12, 2012

interest, and capital gains means Americans will see a significant portion of their cash flow being redirected from their assets to Washington. These tax hikes would not only damage the supply-side of the economy, but would hijack hundreds of billions of dollars of disposable income from the private sector.

In my view, the heart of the recent uncertainty is this *Tax Tsunami*. Potential tax hikes are changing the risk-reward calculation of every business in America. Capital is on strike in the United States. Business and investors will not put risk capital into the economy knowing that there is a strong likelihood that they will be punished by higher taxes and more regulations.

A major and sudden increase in the tax burden aimed at the heart of America's growth engine, small business owners, combined with the subtraction of billions of dollars from the coffers of everyday Americans, and you could have the perfect storm that pushes the U.S. back into recession.

The Bernanke Fed, the Printing Press, and Growth

The Federal Reserve (Fed) appears willing to continue printing money and purchasing bonds in the marketplace until they run out of ink. The Fed announced their latest round of Quantitative Easing (QE 3) on September 13, 2012.[11] The program will be open-ended and purchase $40 billion a month of mortgage-backed securities (MBS) in the open market. The Fed is concerned that, "without further policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions."

The Bernanke Fed has artificially pushed short-term interest rates below free market levels since 2008, and manipulated lower the longer term bond yields like the ten year by implementing non-standard monetary measures (QE 1,2,&3) of printing money to repurchase government bonds. The Bernanke Fed, in my assessment, has not only heightened future inflationary risks, they have created an additional level of uncertainty.

One of the reasons the Bernanke Fed has been able to borrow money and implement these non-standard policies is because the U.S. is currently paying almost nothing to borrow money. In a risky world, there are currently few suitable alternatives. Lending to European or Asian governments looks dangerous. Lending to home buyers looks dicey. Lending to corporations that might go bankrupt is also risky.

Unfortunately, my assessment is that longer-term, this never ending river of freshly printed money will only serve to weaken the US dollar and inflate the value of almost all other asset classes. Inflation will especially impact the price of natural resources and commodities, the basic core ingredients essential in the manufacturing and production of goods and services consumed by U.S. consumers. American's will feel price inflation as their everyday purchases become ever more expensive.

Remember, the Fed has a dual mandate from congress to support job growth but also keep inflation low. I believe the latest announcement positions the Bernanke Fed clearly on the side of lowering the unemployment numbers, and raises the possibility of future inflation to a level this country has not experienced since the 1970's.

Given the unprecedented amounts of liquidity the Fed has pumped into the economy over the last four years, how do they gauge when to rein in their programs and actually turn off the printing presses and begin to drain the dollars? This is the 16 trillion dollar question. The Bernanke Fed, in my assessment, has heightened future inflationary risks and produced an additional level of uncertainty.

If we model a market-friendly solution to the fiscal and tax problems at the start of 2013, and we avoid the *Tax Tsunami*, businesses and investors should become more confident. They will begin to expand,

[11] http://www.federalreserve.gov/newsevents/press/monetary/20120913a.htm

purchase more supplies, equipment and hire employees. The economy should experience faster growth and lower unemployment.

Since American businesses have been operating understaffed and with limited inventory for many quarters, a sudden shift to growth will begin driving up the prices for the basic core ingredients essential in the manufacturing and production of goods and services. The cost of commodities, natural resources, and salaries will all be driven higher. As demand rises, interest rates will follow.

Under this scenario, the government's borrowing costs historically are driven higher. Unfortunately, a small increase in interest rates equates to a large increase in costs. The federal government has been effectively borrowing short-term at close to zero. As interest rates rise from 0% to 2%, the government receives a 200% increase. The government’s short-term borrowing costs for $100 moved from basically zero per year to $2 per year. Consider for a moment a more normalize credit environment where the Federal Government borrows at 5% for a ten-year loan and one gets a better sense of the problem.

This payment crunch is now crippling Greece, Spain, and Italy. Most of Europe has not “right sized” their failed welfare, cradle-to-grave socialistic governments. Nor have they set up payment plans for the last three decades of deficient spending. The United States has turned onto the same road that Europe is trying to back out from. The U.S. Government has been spending approximately $11 dollars for every $7 dollars of revenue received. This is not a workable solution. Paying for the mistakes of the past and shrinking the federal government is the road to fiscal sanity American needs to be travelling.

The American people need an administration that can develop and manage a long-term plan that can “right size” the federal government, lower spending, lower tax rates, lower regulation and grow the economy and provide jobs.

Hope, with a Real Plan

The U.S. government and federal regulations grew by a massive amount over the last dozen years. The anti-business federal regulations, combined with out-of-control federal spending and the threat of the *Tax Tsunami*, are extinguishing business growth, the American entrepreneurial drive, and the spirit of the majority of Americans.

America is at a crucial cross road. I believe that only through more individual freedoms and responsibilities, smaller government, and lower stable taxes will America rekindle the rapid, sustainable economic growth we experienced in the 80’s and 90’s! I am still guardedly optimistic that America will choose the right track, and reassert its leadership as the beacon of freedom, stability, entrepreneurial creativity, and opportunity for all of its citizens and the world.

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